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CURRENCIES AND CREDIT MARKETS

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"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on the whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

M.M. Keynes, *The General Theory of Employment*
p. 159, Macmillan, London

HIGHLIGHTS

The whole industrial world is stuck in a prolonged, structural recession for which we can foresee no sure turning-point. Looking at the general monetary, financial and economic conditions, we see no chance of meaningful, durable recovery anywhere in the industrial world.

Japan's stock price bubble is bursting anew. This crash could have similar cataclysmic effects as the U.S. stock market crash of 1929-33, given Japan's role as the world's biggest creditor.

It has always been the opinion of this letter that the steep rise in U.S. stock and bond prices since late 1990 — now spreading to the rest of the world through the huge exports of U.S. portfolio capital and Wall Street sophistry — is the result of a big "bubble".

Wall Street, though, maintains that this wonderful bull market in financial assets is sound and sustainable. However, it's a fallacy that low interest rates are always bullish for financial markets. Japan is a recent example.

What defines a financial bubble? The emergence of bubbles have always followed the same pattern. Yet, the U.S. situation doesn't fit the normal monetary script. Runaway credit and broad money growth, the normal hallmarks of a bubble, are missing.

In order to distinguish a speculative mania from a healthy bull market, it is necessary to identify the source of the liquidity fuelling the boom. Does it stem from current savings or monetary manipulation? We show that there is no "liquidity-driven" bull market in the U.S.

For weeks now, the big theme affecting financial markets and buoying the dollar has been the strengthening U.S. economy. We review the fundamentals for the dollar. Both structural and cyclical factors continue to keep us bearish.

We explain why the current firming of the U.S. economy is just another false dawn. Early next year, it is in for a relapse.

We continue to steer investors to the most solidly supported markets . . . those markets least affected by the financial mania perpetrated from the U.S. To that end, short-term cash securities and shorter-term bonds of the hard currency countries are most attractive.

CAUGHT IN A BUBBLE

Japan's stock price bubble is bursting anew. The Nikkei Dow has lost more than 20% within barely a month. Since this crash follows a sharp cut in the discount rate by the Bank of Japan to 1.75%, it flashes a warning to the world's high-flying stock markets: low and falling interest rates do not guarantee perpetually bullish financial markets. Obviously, what triggered the slide in Japan is accumulating evidence of a weakening economy.

The new Tokyo crash could have similar cataclysmic effects as the U.S. stock market crash of 1929-33, both domestically and internationally, given Japan's role as the world's biggest creditor. The salient point to see is that this financial meltdown, causing enormous liquidity destruction, is hitting a world economy and financial markets that are vulnerable as never before. And with Japanese interest rates already so low, the Bank of Japan is virtually helpless.

High-strung and over-stressed, financial markets are giving every indication that they are treading on egg shells. Yet there are important differences in the vulnerability and stability of various markets. As we have always warned, the steep rise in U.S. stock and bond prices since late 1990 — recently spreading to the rest of the world through huge U.S. portfolio outflows — constitutes a huge bubble . . . one of the biggest and most elaborate the world has ever known. Essentially, what that implies is that like all bubbles, this one too will end in tears. Importantly, all of this has to be seen against the backdrop of a most fragile world economy. Therefore, in this letter we want to spotlight two big questions: firstly, the origin and extent of the financial bubble; and secondly, the implications for foreign markets and currencies.

U.S. FINANCIAL MARKETS: THE KINGPIN

A prolonged bear market in U.S. stocks and bonds would have serious world-wide ramifications. World stock markets would quickly be pulled into the vortex. Not only have market performances become increasingly correlated, Wall Street has become the bellwether for global stock markets. Largely, it's been U.S. investors that have propelled European and other world stock prices to their present extreme valuation levels. America has exported its stock price inflation to the rest of the world. To us, that's strong evidence that low interest rates in the U.S. have been the source of a widespread bubble centred on Wall Street.

In Continental Europe, however, we draw a sharp distinction between stock and bond markets. European stock markets are narrow and heavily influenced by American money and Wall Street's drumbeat. Its bond markets, on the other hand, are an entirely different matter. Owing to their large size, they have only been marginally influenced by U.S. capital inflows if at all.

In assessing the fundamental stability of national bond markets, we make a simple calculation — one that goes right to the heart of the matter. We compare total domestic credit demand with total available domestic savings. The larger the supply of available domestic savings in relation to credit demand, the more stable the respective bond market. By that measure, unquestionably, the U.S. and Canadian bond markets are among the most imbalanced and vulnerable in the world.

But why worry? The bulls have an impressive list of arguments that supposedly nullify the concerns of the few naysayers such as ourselves. Assuring a continued great bull market, they list the following virtues: (1) financial asset markets are cheap relative to rock-bottom short-term interest rates; (2) long-

term rates should continue to decline; (3) the expectation of sub-par but sustainable economic growth; (4) low, low inflation as far as the eye can see; (5) rising business profits due to ruthless cost-cutting and business restructuring; (6) excess liquidity "*that has nowhere else to go*" and (7), absolutely no danger of a monetary tightening anywhere, least of all in Europe, Japan or the U.S.

WHO CAN TELL A BUBBLE?

While all these points taken together may have lured the great majority into an intoxicating bout of perpetual financial nirvana, it certainly doesn't disprove the existence of a bubble. In fact, what's the toughest question for financial players today? It's this: What, if anything, could abort today's financial gravy train? We get vacant stares when we ask this question. Actually, that's an ominous symptom. History shows that virtually all policymakers and market participants, whether novices or experts, have always failed to recognize an asset bubble before it burst. Unbridled, blind euphoria always existed right to the end.

We only have to recall the U.S. financial bubble of 1928-29 or the Japanese and British bubbles of 1988-90. In all of these three cases, policymakers and experts showed a complete ignorance of the prevailing dangers. Instead, they were always quick to offer comforting explanations as to why the extraordinary surge in asset prices was healthy and durable. Still, every time there were a few lonely voices sounding alarm. As a study of the most recent example, we recommend the memoirs of Nigel Lawson, who as the Chancellor of the Exchequer in the U.K., presided over the rampant British house price bubble.

Obviously, even the most recent lessons of history have gone unheeded. Above all, low inflation and sub-par economic growth are widely regarded as sure proof of a balanced economy and the absence of a bubble. In reality, it's precisely these two conditions, when combined with prolonged and aggressive monetary ease, that have always produced great asset bubbles. When Japan experienced its super-sized bubble of the late 1980s, its inflation rates were persistently below 2%.

THE COMMON FALLACIES OF BUBBLES

Where lies the critical fallacy? In the blind assumption that low inflation must automatically imply a healthy economy and booming financial markets. But that's not necessarily so. To buoy stock and bond prices requires more than just low inflation. It needs increased buying power from investors and savers. In a healthy market, this additional buying power comes from rising savings; in the case of a bubble, it's spurred by monetary sources.

Typically, to repeat, all asset bubbles have occurred when aggressive monetary ease had disappointing effects on the real economy. As the central bank keeps its spigots wide open, the money instead floods into the asset markets and forces up asset prices. In this way the emergence of bubbles has always followed the same pattern. Yet, they may differ in their targets and in particular in the mechanism that brings them about.

The U.S. bubble of 1928-29 centred on the stock market. By contrast, the Japanese bubble of 1988-90 involved both stock and real estate prices. In turn, the British bubble of the same period inflated real estate prices with a vengeance. As for the present U.S. bubble, it exclusively involves stocks and bonds

while real estate prices are more or less mired in deflation.

More intriguing and more important are differences in the institutional and financial setting of these bubbles. Both the Japanese and British bubbles of 1988-1990 manifestly revealed their true nature in runaway credit and broad money growth. Yet, despite these blatant danger signals, nobody was able to decipher the handwriting on the wall.

In a similar vein, the U.S. financial bubble of the 1920s until 1928 was also visibly powered by a rampant bank credit and broad money expansion. Then, speculative credit shifted heavily from banks to brokers. That's significant from a monetary point of view because rising broker loans, being refinanced by other investors, were therefore not reflected in the money supply. Money growth actually stagnated. What happened was that existing deposits were used much more intensely . . . circulated much more rapidly, in other words.

DIFFERENT, THOUGH A BUBBLE ALL THE SAME

What about the present U.S. financial boom? Conspicuously, it seemingly doesn't fit the normal monetary pattern of asset bubbles. Runaway credit and broad money growth, the normal hallmarks of bubbles, are missing. On the contrary, broad money is sluggish as never before in the postwar period. How can there be a bubble if rampant money and credit creation are absent? Well, there can be and there is. We need to explain.

The key to identifying a bubble is an investigation of supply and demand. What is the demand for funds and where is the money financing it coming from? The following statistics from the Federal Reserve's Flow of Fund Accounts covering the twelve months to the end of June 1993 detail the three main components of demand.

To begin with, the U.S. domestic credit and debt expansion during the period totalled \$551 billion. Of this amount, the Federal government borrowed \$279 billion, Federal agencies \$138 billion and state and local authorities another \$70 billion, for a grand sum of \$487 billion or 88% of the total. The rest went directly to the consumer. The business sector borrowed virtually nothing. In addition, government-sponsored agencies (such as the Federal Mortgage Assurance Corporation) fronted part of the consumer debt expansion by securitizing mortgages and selling them as bonds to individual and institutional investors. Actually, therefore, government-related borrowing was a much higher proportion of total borrowing than the above figures reveal.

In addition, corporations tapped the equities market issuing new securities totalling a net \$41 billion. Thirdly, U.S. investors were significant purchasers of foreign securities. In an apparent diversification drive, U.S. investors poured an unprecedented amount — a total of \$76 billion during this period — into foreign stock and bond markets.

In total, these credit and portfolio flows add up to \$668 billion. For a one year period, that's an incredible sum of money. What's even more incredible is the fact that this occurred alongside booming U.S. securities prices, indicating a tremendous buying pressure in the domestic financial markets.

Having calculated this sum, we finally come to the acid test of every "bubble". It concerns the source

of the money. Where did the \$668 billion that flooded the U.S. and world financial markets come from?

THE SOURCE OF THE FINANCIAL BOOM

Critically, the most important thing to see is that these credit and portfolio flows vastly exceed the supply of U.S. national savings. At best, net national savings totalled only \$300 billion per annum. Given this enormous savings gap — between \$300-\$400 billion — what then was able to fuel the unprecedented buying frenzy in the securities markets?

In short, the primary and chief actor in this saga is none other than the U.S. Federal Reserve Board. It supplied the necessary fuel with a vengeance employing two techniques: (1) by loading the banks with excess reserves; and (2), by slashing short-term interest rates to rock-bottom levels which in turn have forced bank deposit rates below the inflation rate. These measures might appear trivial to many people. Yet, these actions helped to unleash many hundred of billions of dollars into the stock and bond markets.

Setting the chain of events in motion are the Fed's record-high purchases of government bonds. These purchases totalled \$36 billion during the year to mid-1993 and served to flood the banks with reserves. The second key actors, magnifying the Fed's action, are the banks.Flushed with mounting reserves pumped in by the Fed and facing feeble credit demand, banks used the reserves to buy Treasury and agency bonds at a scale unmatched in history. Their purchases totalled an additional \$94 billion in the reference period and played a crucial role in forcing down the long- and medium-term rates of interest.

Without question, if the Fed and the banks had not participated in this way, the U.S financial mania could not have developed. What greatly reinforced the buying pressure in the stock and bond market was the fact that the Fed simultaneously pared its Fed funds rate to an extremely low 3%. By doing so, it unleashed two additional buying binges in the stock and bond market: financial institutions outside the banking system — non-banks such as pensions funds and brokers — and individuals.

In the case of non-bank institutions, they are riding the yield-curve with crazy abandon, financing the bulk of their higher yielding bond holdings at rock-bottom interest rates in the repo (money) market. The brokers and the Treasury dealers are the biggest yield-curve players outside of the banking system. After having added \$60 billion to their bond portfolios during the 12-month period to mid-1993, they held a total of \$270 billion in government or agency bonds. To put this into perspective, that's an amount ten times their holdings of the mid-1980s and is equivalent to the annual federal budget deficit.

Last but not least, individual investors have played a key role in the financial boom through massive asset switching. Starved for income on short-term investments due to the Fed's persistent efforts to keep the Fed funds rate low, and in a desperate search for higher yields, they bolted out of low-yielding liquid assets and into stocks and bonds, both directly and through mutual funds. So far this year they have funnelled more than \$20 billion per month into stock and mutual funds, a record pace. That follows total purchases of \$202 billion in 1992 and \$130 billion in 1991. In a space of less than three years, these flows amount to over \$500 billion. That exceeds the entire previous flows of the whole postwar period.

In order to distinguish a speculative mania or bubble from a healthy bull market, as we said earlier, it is necessary to identify the source of the liquidity fuelling the boom. Does it stem from current savings

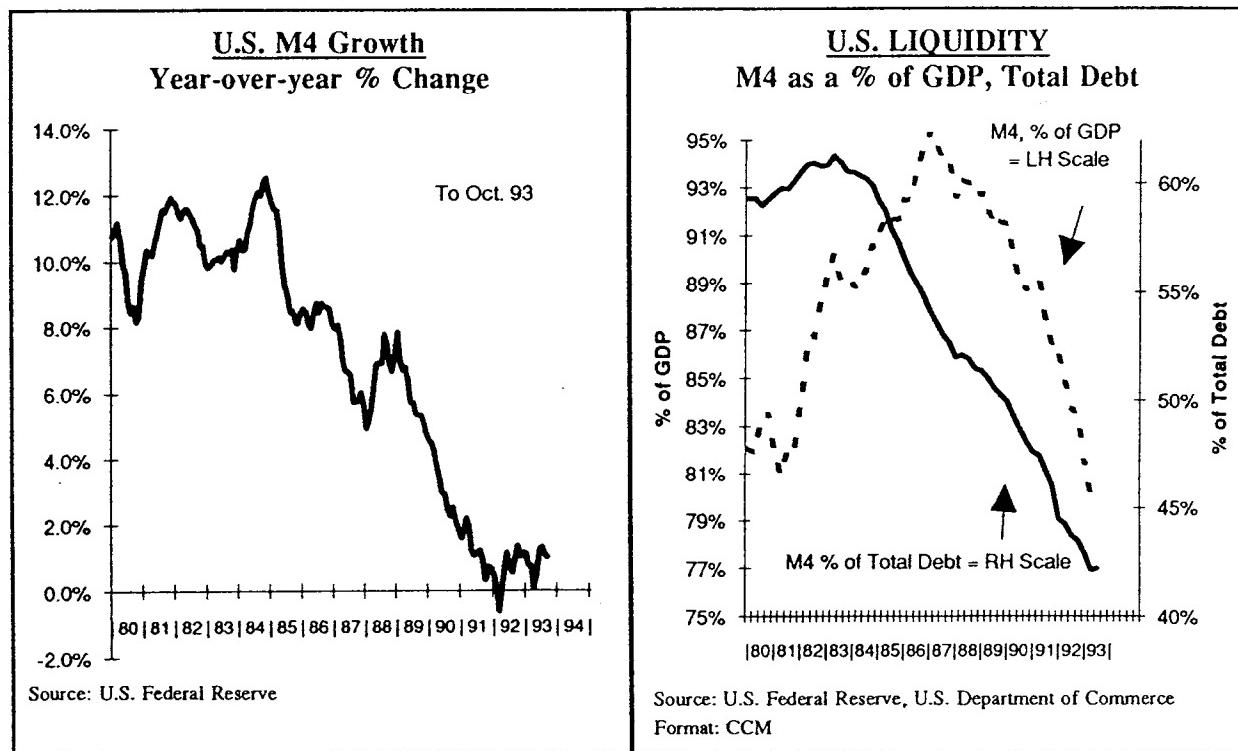
or monetary manipulation? Our investigation leaves no doubt. In the case of the U.S., glaringly, it is Fed manipulation and not savings growth that gave rise to appalling financial imbalances. The question still remains as to when and how this bubble will end. Nevertheless, it's important to first realize its precarious nature.

WHERE IS THE LIQUIDITY?

Typical of the general failure to understand the true forces at work behind the U.S. financial boom is the widespread talk of an excess of liquidity flooding the markets . . . a so-called "*liquidity-driven*" boom. But that's absurd. A quick glance at the facts reveals that the internal liquidity of the U.S. — as measured by broad money (M2, M3 or M4) — is shrinking as never before in the postwar period.

In assessing U.S. liquidity trends, we must be careful to distinguish between the supply of new liquidity, as measured by broad money growth, and the pool of existing liquidity represented by the broad money stock. The charts below highlight some striking trends. The chart on the left shows the growth of M4 which continues to expand near the lowest pace on record. Clearly, there is no supply of liquidity here.

The right chart shows the stock of liquidity (M4) both relative to economic activity and total debt. What we see is that the stock of liquidity, in the beginning overly high due to the excessive money growth of the 1980s, is being run down to near-historical lows relative to Gross Domestic Product (GDP). In relation to total debt — a more critical measure — liquidity is at a frightening, unprecedented low. What these charts reveal is that far from swimming in excess liquidity, the U.S. economy is being severely drained of it. Put another way, rather than being driven by the force of excess money, the bubble is being blown up by a twisted flight from liquidity . . . a so-called shift in liquidity preference.



As already said, this U.S. financial bubble is absolutely unique in that it is marked by near-zero broad money growth. We identify two main reasons for this phenomenon: first, very sluggish bank expansion implying very little deposit creation and therefore low growth in broad money; second, the buying spree in the U.S. stock and bond market, manipulated by the actions of the Fed, is largely driven by non-banks. Above all, it is individual investors switching their savings deposits into mutual fund shares and institutions — for example brokers — playing the yield curve that poured liquidity into the bubble.

In this context, the salient point is this: Only banks create money (deposits) to the extent that they expand their loans and investments. While their bond investments have grown sharply, most of the now money pouring into the financial markets is from non-banks. In this way, it is possible that a speculative frenzy can occur without any change in the broad money supply.

FEARS OF RECOVERY

According to the consensus, complacent as ever, the recent correction in the U.S. bond market is more or less attributable to a strengthening U.S. economy. In our view, if that is so, it reveals the extreme fragility of the bubble if it can't stand some good news. Apparently, many nervous speculators are eager to lock in their capital gains.

Considering the widely overleveraged bond portfolios of banks, brokers and others, these jitters are perfectly understandable. As a matter of fact, this is how speculative bubbles are pricked — the bolting of speculators and investors. It's not necessary that some cataclysmic event occur. The higher that markets soar and the more overstretched valuations become, the more violent each successive correction becomes. Progressively, that seems to be the case in U.S. long-term bonds this year, each successive correction in rates being sharper than the one before.

How well is the U.S. economy really doing? It is a favourite argument — particularly of the dollar bulls — that the U.S. economy is doing well in comparison with all the other OECD (Organization of Economic Cooperation and Development) countries, and in particular, against Germany's expected GDP decline of 2% for 1993. It's surely appears to be an impressive comparison. Only, it conveniently overlooks the drastic differences in the cyclical pattern and the monetary conditions between the two countries. The U.S. economy is in its fifth year of sub-par growth despite extremely aggressive monetary easing. Germany is in its first year of recession following its unification boom while the Bundesbank continues to keep the brakes on.

Yes, the resulting financial boom, due to its ephemeral profits, has certainly acted to sustain consumer demand. But it has exacted a dangerous price in the form of a financial bubble. When the Wall Street "bubble" finally bursts, as it eventually must, the U.S. economy will be in trouble.

A DECEPTIVE INVESTMENT BOOM

There is a fanciful belief in the markets that the current U.S. recovery is on a healthy and sustainable foundation. Its outstanding qualities are seen in strong investment, high productivity growth and low inflation. Above all, it has been assumed that sharply lower long-term interest rates will further spur capital investment and consumer spending on durables. All of these arguments are misinformed.

Ever since early 1992, at least as reported, U.S. business investment in plant and equipment has risen at a double-digit pace. Could this be the beginning of investment-led growth, heralding the productivity miracles that so many reports are predicting? A closer examination points to a different conclusion.

To begin with, it's been a rather lopsided investment boom being centred on "information-related equipment" (mostly computers) and on the commercial sector of the economy. Manufacturing investment has only recovered moderately and is still well below the levels of 1990.

What's important to know is that at least half of this boom in computer investment is not the result of actual spending but of sharply falling computer prices and government estimates of the increase in computational power. In the third quarter of 1993, for example, actual spending on computers grew at an annual rate of \$49 billion. However, in real GDP accounts, it was counted as \$104.9 billion.

Also a bit strange is the strong rise in capital spending on transportation. What it really reflects is a large increase in automotive leases. Although this trend largely reflects consumer buying of cars, it is categorized as an investment by the leasing company. Adjusting for these two influences, business investment is weak.

A FALSE PRODUCTIVITY MIRACLE

Speaking of productivity growth, we need to make an important point: There is a crucial difference between the productivity growth that results from "downsizing" and labour shedding which involves little new investment and that which is the product of strong investments in goods-producing machinery. Computer investments are good for cost-cutting but usually do not enable companies to produce more goods. For that to happen would require more investment in goods-producing machinery. In fact, this latter type of investment, after taking depreciation into account, is almost at a zero pace.

Another big fallacy in the euphoria about a "computer- and productivity-led" recovery in the U.S. concerns its short-term growth effect. Capital spending is the one and only GDP component that has a demand and a capacity effect. What matters in the business cycle are solely the demand effects, meaning the output, employment and income growth resulting from the production of capital goods and building activity. Separate and apart from these short-term demand and output benefits are the later capacity effects.

In terms of cyclical dynamics, building construction has the highest leverage on economic growth due to the fact that it has the highest multiplier effects on employment and income. It's a fact that all major depressions were marked by building slumps. While construction has recovered from its 1990 lows in the U.S., it still remains some 20% below its peak of 1989. Despite a lot of bullish talk and sharply lower long-term interest rates, there have been no gains in construction during the course of 1993.

Now compare the leverage effects of current computer production increases on employment and wages with those of building. We guess they are negative in the computer industry. Owing to its own enormous productivity gains, the computer industry is able to boost production while slashing its labour force. Given the fact that there are no employment and income gains, the strong positive contribution of computer investment to real GDP growth is purely statistical.

FALSE GROWTH ALARMS

For weeks now, the big theme affecting financial markets and buoying the dollar has been the strengthening U.S. economy. Playing the game of expecting a robust U.S. recovery that never arrives is apparently a pastime of which the markets never tire.

During the first half of 1993, U.S. real GDP grew at a very feeble annual rate of 1.3%. In the third quarter, growth spurted to an annual rate of 2.8%. Convinced that the sharply falling long-term interest rates would stimulate the economy, the markets immediately jumped to the conclusion that an accelerating recovery is under way.

A more careful look at the third quarter figures ought to have raised serious doubts about this assumption. A most ill-structured recovery is evident. All the growth in GDP came from consumer spending, entirely financed by heavier borrowing and reduced savings.

A NEW GROWTH CATEGORY: HURRICANES AND FLOODS

What makes us even more wary of U.S. growth forecasts are the huge distortions in the U.S. economic data due to the vast flood damages in the mid-west and the two hurricanes the previous year. Last year, casualty insurance covering hurricane damages amounted to \$60 billion. That's a large influence when compared with total real GDP growth of \$189 billion in 1992. Upon closer inspection, it's evident that the hurricanes were the main cause of the GDP acceleration in the second half.

Common sense says that economies don't get richer by way of hurricanes and floods. Yet, according to U.S. economic statistics, that's precisely what happened. As a matter of fact, the more meaningful net domestic product (NDP, which is GDP less depreciation) shrank in the third quarter of 1992. But real GDP, the aggregate that markets exclusively focus on, jumped by \$42 billion or 3.4%, both taken at an annual rate. The whole of this GDP growth reflected the writing-off of the depreciated value of business plant and equipment destroyed by the hurricanes. We thank Gene Birnbaum who drew our attention to this point.

This year, it's the mid-west floods that have produced the same crazy statistical effects though on a smaller scale. For us, it's beyond question that the current U.S. growth acceleration is largely flood-related, bearing in mind that the practice of annualizing these figures grossly magnifies these distortions. In conclusion, our highly critical assessment of the U.S. economic situation is determined by two considerations: First, the economy is fundamentally much weaker than most people realize; and second, the outlook is fraught with risks associated with the eventual bursting of the financial bubble.

GLOBAL GROWTH PROSPECTS

Being pessimistic on the U.S. economy, as we have often said, does not mean that we are necessarily optimistic about the prospects for other countries. The whole industrial world is stuck in a prolonged, structural recession for which we can foresee no sure turning-point. Looking at the general monetary, financial and economic conditions, we see no chance of a meaningful, durable recovery anywhere in the industrial world. A further deepening of the world recession seems to be a more probable outcome to us, though we would not dare to venture a forecast by how much.

As to the world outlook, not surprisingly, our most notable point of dissent with the consensus view concerns the U.S. economy. According to this view, the U.S. economy is embarking on a sustained and increasingly robust recovery, thus leading the world out of recession. Though its pace may be slow, a sustained recovery is taken for granted.

To us, this smacks a bit of 1930. Before we can believe in a sustained, sufficiently strong economic recovery, we must first see robust profit growth and strong investment, both of these always occurring together. We don't see anything like this happening anywhere. Taking into account that the U.S. economy is now in its tenth quarter of a cyclical recovery, its performance is abysmal . . . certainly not the foundation for a sustained recovery.

THE CASE FOR THE HARD CURRENCIES

As far as the outlook for the dollar is concerned, we distinguish between long-term structural impediments and short-term influences. From a long-term perspective, the dollar is doomed due to many years of undersaving and underinvestment. Only over the short-run is the dollar supported and here only by false perceptions of a sustained U.S. recovery.

Two factors crucially distinguish the D-mark and other hard currencies in Europe from the U.S. dollar: firstly, the absence of the kind of financial excesses that have put the U.S. economy and its financial markets at risk; and secondly, far stronger savings and investment fundamentals. While Germany, too, has an outsized budget deficit, it is at least matched by high domestic savings.

As well, German interest rates have fallen sharply. But in diametric contrast to the U.S. experience, rates have declined even though the Bundesbank has kept its foot on the monetary brakes and maintained an inverted yield curve for the longest time. The chief pillar of the German bond market is the German individual investor whose motive, given the expectation of steadily declining inflation, is long-term investment.

Yet these statements may seem strange given the statistics that show a stupendous flow of foreign capital pouring into German stock and bond markets. Recently, the International Bank Credit Analyst warned its readers that the German bond and currency markets were vulnerable to a decline in capital inflows. We quote: "*Germany's high interest rates have attracted net capital inflows in the past 12 months of close to DM 175 billion. Germans themselves have poured money out the country in the amount of almost DM 150 billion . . .*" An explanation is in order.

The big flood of foreign DM-bond purchases began only a year ago. Not so curiously, its onset coincided with an announcement by the Kohl government that a 33% withholding tax on the interest income of domestic investors would be introduced. Promptly, domestic buying of bonds halted. Simultaneously, foreign buying skyrocketed. It is surmised that most of these "foreign" buyers are largely German individuals disguising themselves as foreigners in order to evade the withholding tax. Cash flows out of the country only to return as tax-free non-resident money purchasing DM-bonds. A main conduit for these flows are the German bank branches in Luxembourg which have accounted for DM 80 billion in DM-bond purchases over the last 12 months.

In comparison to the U.S. bond market, which to us looks more like a casino, the DM-bond market is

solidly underpinned by savings and conservative investors. The German stock market, however, is quite a different matter. Here, foreign speculators dominate.

THE TRUE CASE FOR THE DOLLAR

As we mentioned, we are bearish on the dollar for both structural and cyclical reasons. A renewed flare-up of U.S. recovery fever is misplaced. That will become evident early next year and when it does, the dollar will be very vulnerable.

The balance-of-payments fundamentals for the dollar are actually going from bad to worse. Particularly ominous is the dramatic deterioration in the U.S. trade and current account, occurring despite sluggish domestic demand growth. Since 1991, the U.S. deficit in merchandise trade has jumped from \$73.8 billion to \$130 billion per annum currently.

To recall, the major rationale behind the bullish dollar forecasts is the historical experience that it always soared whenever the U.S. economy went into a strong cyclical recovery relative to the rest of the world, even though the trade balance used to deteriorate under these conditions. It is obvious to us that this same old simplistic dollar bull story has again been adopted by the currency trading community. Therefore, for a while at least, it becomes a self-fulfilling prophecy.

Nevertheless, what these dollar bulls have lost sight of are the economic and monetary conditions that provoked the pro-cyclical capital flows which buoyed the dollar in the past. In particular, we note four: (1) a truly booming U.S. economy; (2) surging credit demand; (3) a progressive monetary tightening by the Fed; and (4), the rising interest-rate advantages of the dollar against the D-mark. The most important component in these flows were bank flows. Given a booming economy, strong credit demand and a tight supply of reserves by the Fed, the American banks stepped up their borrowing in the Euro-market. It was this external financing demand of the U.S. banking system that was a main influence on the dollar's usual cyclical rise.

Of these four conditions, not a single one is valid today. Banks are swimming in reserves with near record-low demand for bank credit and domestic deposits are cheaper than Euro-borrowing. Investors, in search of higher yields abroad, are at the same time shifting funds out of the country at an unprecedented rate of almost \$100 billion. And since foreign portfolio inflows have slowed as well, the U.S. long-term capital account has registered a record-high deficit.

Just think of it: a soaring U.S. trade deficit, record-low short-term interest rates, and large and rising portfolio outflows. Just what is keeping the dollar so strong? In short, huge, speculative hot-money flows. What we see is just an additional speculative bubble.

In the same vein, it is simply taken for granted that the dollar must rise as the DM-dollar interest rate differential narrows. The irony is that the currency markets have accepted this as a plausible rationale for dollar strength even though the DM's secular rise against the dollar since 1971 has taken place with DM-interest rates that were consistently well below dollar rates. This is the first extended time in the postwar period that the reverse is true. Seen in this light, it's a fanciful notion to make a bearish case for the DM out of narrowing interest rate differentials.

CONCLUSIONS

Worldwide, economies are growing slower than productivity. The result is a steady increase in structural unemployment. There is no chance anywhere for sustained, strong growth which implies further low inflation.

Does continued low inflation and slow growth ensure perpetual bull markets in bonds and stocks? Of course not. Speculative bubbles all have their limit with or without a cataclysmic event. As we've shown for the U.S., liquidity is already the lowest on record.

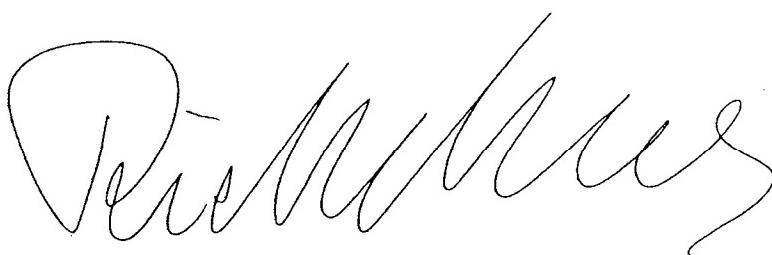
Ominously, Japan's Nikkei stock index has fallen 17% in a month despite a sharp discount rate reduction by the Bank of Japan to an all-time low of 1.75%. Unexpected weakness in the economy and related financial troubles have unnerved the markets.

While illusions about a U.S. recovery are lending temporary strength to the dollar, long-term structural trends in the U.S. economy point to a return of the secular decline in the currency.

The greatest and most predictable threat to the world stock market bubble is a relapse in the U.S. economy next year. However, bubbles do not necessarily need something to prick them. It can simply be exhaustion.

It's hard to say what's worse, the stock market bubble or the U.S. bond bubble. Whatever the case, one is likely to follow the trend other. The important thing is to be fully aware of the ultra-extreme risks presently and to take the necessary precautions.

We continue to steer investors to the most solidly supported markets, those least vulnerable to a bursting of the bubble. We therefore must continue to recommend that investors focus on short-term cash securities and shorter-term bonds of the hard currency countries — Germany



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